18 T.C. 112 (1952)

A loss is deductible as a business bad debt if it bears a proximate relationship to a business the taxpayer is engaged in when the debt becomes worthless.

Summary

Gutman and Goldberg, partners in a law firm, sought to deduct losses related to mortgage interests as business bad debts and business losses. The Tax Court addressed whether these mortgage interests were capital assets and whether the losses were incurred in the ordinary course of their business. The Court held that the mortgage interests were not capital assets because the partnership held them primarily for sale to customers. The loss on the Harrison Avenue mortgage was deemed a business bad debt, fully deductible, while the loss on the Crotona Avenue mortgage was deductible as a business loss. The court also disallowed a capital loss deduction on the sale of a personal residence.

Facts

Prior to 1929, Gutman and Goldberg had a partnership with Leopold Levy which was engaged in the real estate and mortgage business. After Levy's death in 1929, Gutman and Goldberg formed a new partnership continuing their law practice. The new partnership continued a greatly diminished real estate business similar to the old partnership. In 1930, they and Levy's estate formed Resources. In 1941, Resources liquidated and Gutman and Goldberg reacquired interests in the Harrison Avenue and Crotona Avenue mortgages. Gutman and Goldberg subsequently accepted less than face value for the Harrison Avenue mortgage. They made efforts to sell these mortgages but were unsuccessful. Elsie Gutman sold a property in Massapequa at a loss.

Procedural History

The Commissioner disallowed the deductions taken by Gutman and Goldberg related to their interests in the mortgages, treating them as capital losses. The Commissioner also disallowed a deduction for a long-term capital loss on the sale of the Massapequa property. The taxpayers petitioned the Tax Court for review.

Issue(s)

1. Whether the Harrison Avenue and Crotona Avenue mortgage interests were capital assets.
2. Whether the loss sustained on the Harrison Avenue mortgage was a business bad debt or a nonbusiness bad debt.
3. Whether the loss sustained on the Crotona Avenue mortgage was deductible as a business loss.
4. Whether the loss sustained on the sale of the Massapequa property could be offset against the gain realized on the sale of the Jamaica property.

Holding

1. No, because Gutman and Goldberg held the mortgage interests primarily for sale to customers in the ordinary course of their real estate and mortgage business.
2. The loss was a business bad debt because the debt bore a proximate relation to the real estate and mortgage business Gutman and Goldberg were engaged in when the debt became worthless.
3. Yes, because Gutman and Goldberg held their interests therein primarily for sale to customers in the ordinary course of their real estate and mortgage business.
4. No, because the properties were separate and distinct residences.

Court’s Reasoning

The court reasoned that the old partnership was in the real estate and mortgage business, holding real estate and mortgages for sale to customers. The new partnership continued in the same type of business, albeit at a greatly reduced volume. Therefore, the mortgage interests were not capital assets under Section 117(a)(1) of the Internal Revenue Code. For the Harrison Avenue mortgage, because they accepted a lesser amount, there was no sale or exchange. The court looked to Section 23(k)(4) to determine if it was a business or non-business bad debt. Citing *Robert Glurett, 3rd., 8 T.C. 1178*; *Jan G.J. Boissevain, 17 T.C. 325*, the court noted that the debt must bear a proximate relation to a business in which the taxpayer is engaged at the time the debt becomes worthless. Because Gutman and Goldberg were in the real estate and mortgage business in 1944, the loss was a business bad debt and fully deductible. The loss on the Crotona Avenue mortgage was deductible under Section 23(e)(1). Regarding the Massapequa property, the court found they were separate and distinct properties. Citing and comparing *Richard P. Koehn, 16 T.C. 1378*, the court held that the loss could not be offset against the gain from the Jamaica property.

Practical Implications

This case illustrates the importance of demonstrating that a taxpayer’s activities constitute a business, and that the property at issue was held primarily for sale to customers, to qualify for ordinary loss treatment rather than capital loss treatment. It also highlights the need to establish a proximate relationship between a debt and the taxpayer’s business to deduct a loss as a business bad debt. This case is still relevant in determining whether real estate losses are ordinary or capital. Taxpayers seeking to deduct real estate losses should demonstrate their intent to sell, frequent sales activity, and advertising efforts.

